DOW THEORY LETTERS INC.

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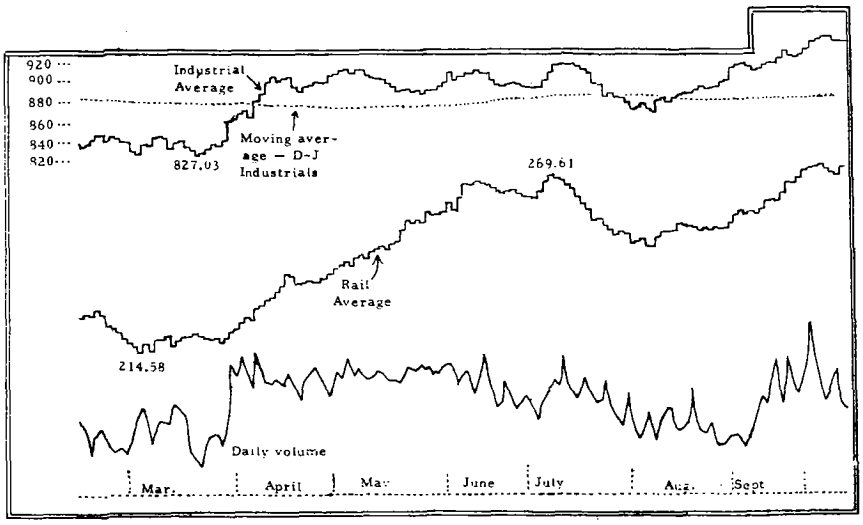
THE MARKET: On October 7 the Dow Industrial Average rallied to its highest point since the 1966 bull market high of 995.15. Rails pushed to their highest peak since the 274.49 all-time high of 1967 (the recent Rail high was 273.04). By so doing, the Industrials interrupted the pattern of annual declining tops since 1966, a pattern which I have often referred to. As matters now stand, we have an Industrial all-time high (995.15) in 1966, and a second lower peak (956.68) recorded a week ago.

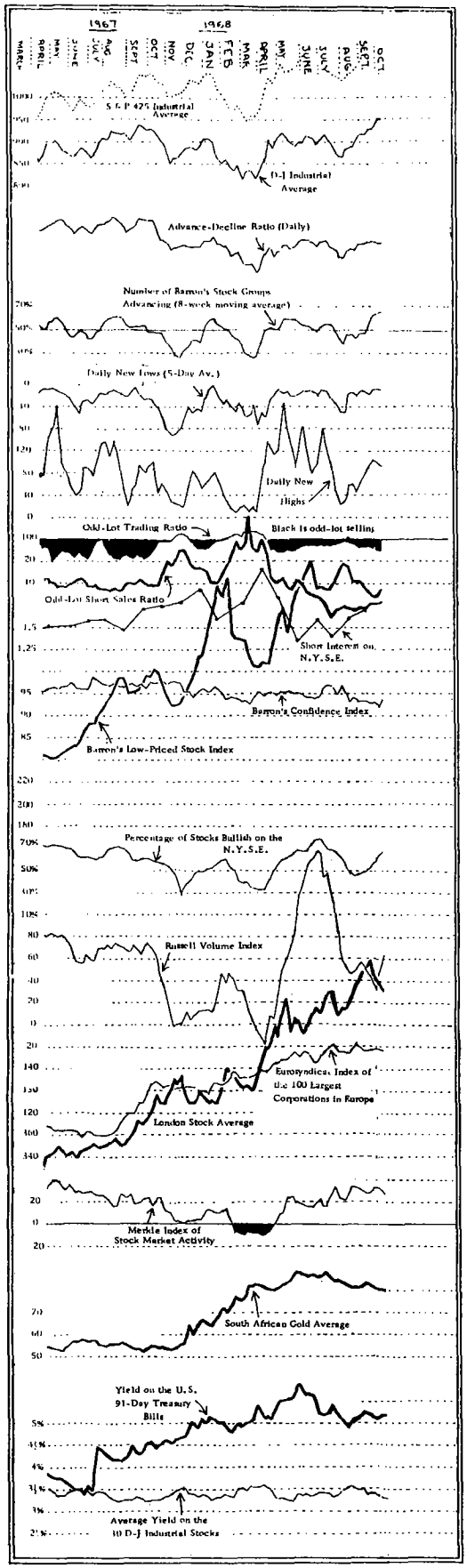
Does this change my view of the market? The answer is, it does not. I continue to view the entire price structure since 1966 as part of the most deceptive (and most inflation-inspired) secondary upward correction in stock market annals. Undoubtedly, aside from inflation hedging, a good deal of the recent buying was brought on by the apparently "sure thing" placement of Richard Nixon in the U.S. Presidential spot. Nevertheless, I fail to see how a more conservative administration can provide any lasting impetus to an inflation-inspired market. If the market is up because people are hedging against a depreciating dollar, it is unlikely that the market will continue up in the face of a turn toward fiscal sanity? Yet some degree of fiscal sanity will almost surely result from a Nixon Administration.

The pathetic part of it is that when a balloon (the U.S. monetary structure) is blown way out of proportion, there are only two things that can happen. The balloon can continue to inflate to the bursting point— or the air can be released. Either way, Mr. Nixon will have a mountain of problems on his hands. If Nixon chooses the deflation road, the whole economy could run into trouble as profits collapse, and the U.S. Treasury charges into the bond market like an express train. If the balloon is allowed to continue expanding, it will only be a matter of time before the explosion is heard.

I have been directing attention to the lagging Utility Average, an Average which is now near a four month low. The Utilities have been quietly warning Wall Street of money pressure, and over the past few weeks (see later section on bonds) the debt market has confirmed these fears.

As economist-publisher Elliot Janeway stated in his latest report, "Last summer's quick picnic in the long-term (bond) market is collapsing into another panic.



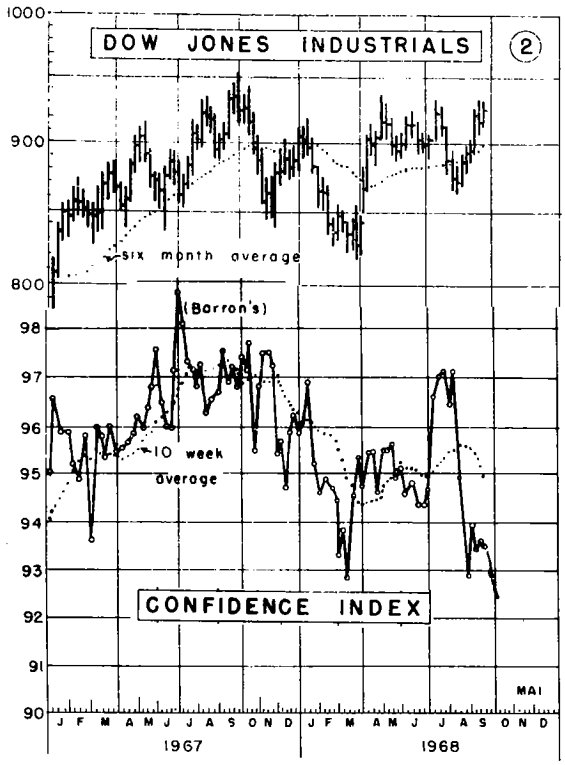

1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Eurosyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Merkle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 10 D-J Industrial Stocks

The response of the short-term market to the Fed's exercise in pulling rates down is to push them up again." Janeway has hit it on the button. Last week the Treasury list of bonds was slaughtered across the board—day after day. This type of action on the money front is seldom a sign of anything but trouble.

What the bond market is telling us is that if the boom is to continue, money rates are going up—and fast. In fact, bond yields could easily go to new record highs, thereby confounding the experts who only a few months ago were announcing that the great 22-year bear market in bonds "is over." Last week I counted 19 out of the 33 listed U.S. Treasury bonds at yields of 5.3% or better. Six of the 19 were yielding better than 5.4%. This means that a selection of the choicest long-term debt in the nation is yielding 2% more than the average yield on the D-J Industrials. Frankly, the whole picture is (in my opinion) beginning to read like shades of 1966.

I continue to recommend that my subscribers treat this whole market as what it is—a mighty correction in a primary bear market. This is a time for patience—and caution. When this market structure starts tumbling, the exits could be choked in a day, in an hour. I do not want any of my subscribers to get caught in this type of rush, and I therefore advise staying with the Dow Theory principle of being out of the market during primary bear phases—no matter how deceptive. The bond market is talking today, and it may not be long before the stock market too will have its say. Let's play it safe.

CONFIDENCE INDEX BREAKS: In Letter 406 I presented a detailed discussion with long and short term charts of Barron's Confidence Index (CI). Because of last week's developments, I am including the short term chart again (chart courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514).



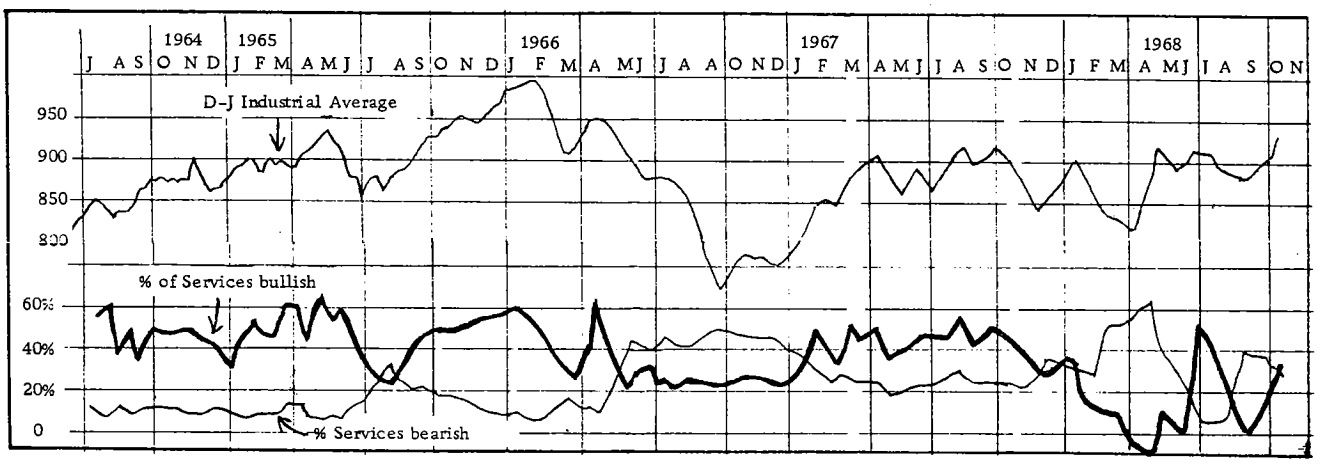
Note that the low for the CI in 1967 was 93.5. The 1968 low for the CI came in March at 92.8. In August and September the CI dipped to the 92.9 area. Thus, a sort of "triple-bottom" was created during 1967-68 at 92.8 to 92.9. A week ago (October 4) Barron's published a figure of 92.4 for the CI. This meant that the CI had broken all lows going back to late-1966. If the CI has any predictive value, the slide from the 97.1 peak of July 1968 to the new two-year low of 92.4 (October, 1968) should mean rough sledding for the market over the period ahead.

PROFESSIONAL OPINION: Wall Street is a strange place. It pays millions of dollars for expert advice, but it's always skeptical of that advice. And for good reason. When 50 doctors or 50 lawyers agree on something, there is a good chance that that number of experts are very close to the truth. But when 50 Wall Street analysts agree on something, even the analysts themselves become uneasy. They know from experience that the majority (even the majority of professionals) is seldom correct.

William P. Hamilton, second editor of the Wall Street Journal (and a leading Dow Theorist) said that he "never knew a time when the majority of professionals were correct." Time has born out Hamilton's rather cynical (but keen) observations.

Investors Intelligence releases periodic tabulation of the bullish or bearish stand of approximately 60 investment services. I have been charting these statistics since mid-1964 (I believe I am alone in doing this). That chart (included in this Letter on page 3) is of more than passing interest. I have noticed that the market is on rather thin footing whenever 55% to 60% of the services turn bullish. This has occurred on roughly 6 occasions since 1964. It occurred in July, 1964, March to May, 1965, January, 1966, again in April, 1966, August, 1967 and during June, 1968. Except for the first period of July, 1964 (which was accompanied by a little weakness in the Dow), each of the other periods of bullishness was followed by sizable drops in the Dow and the general market.

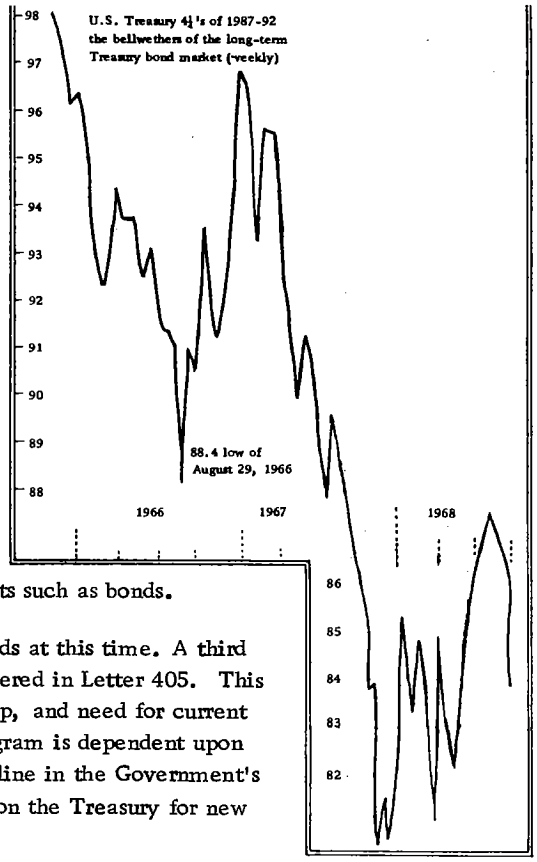
Conversely, anytime the bearish percentage of services rises into the 30% to 50% area (particularly if the bullish percentage is below the bearish percentage), the market is moving into considerably firmer ground. This occurred in July, 1965, July to December, 1966, and February to May, 1968. The results of this type of action are easily traced on the chart.


1964
1965
1966
1967
1968
J A S O N D J F M A M J J A S O N D J F M A M J J A A O N D J F M A M J J A S O N D J F M A M J I A S O N
D-J Industrial Average
950
900
850
800
% of Services bullish
60%
40%
20%
0
% Services bearish

What of the present period? The latest tabulation shows the bullish percentage of services at about 37%, the bearish dropping to about 34% with the bullish percentage moving slightly above the bearish percentage. As I see it, this study is now in neutral ground but definitely away from its bullish reading of the past month or so. The obvious danger signal would be a rise in the bullish percentage of the 55% or above area.

MONEY, MONEY: Here is a picture of our old friend, the bellwether of the U.S. Treasury bond market or the $4\frac{1}{4}$ of 1987-92. This is the Treasury bond which is watched by all bond traders and investors, and it is watched in the same way that stock market practitioners watch mighty General Motors. (Note: Par for a bond is 1000 or $1000. The figure 84 on this chart actually denotes a price of $840, and all fractions in Treasury bond quotes denote 32'nds of a dollar. Thus 84.2 means 84 and 2/32nds).

So much for technical bond jargon. What is important is that here we see Uncle Sam's bellwether debt unit selling at 84¢ on the dollar. In other words, even though the U.S. guarantees with all its assets and taxing power to pay off these bonds at 100 upon maturity date, the market will only pay 84¢ on the dollar for them. A number of factors can determine bond prices. (1) The popularity of a bond itself. (2) Its "coupon" or interest rate as compared to current interest rates on comparable instruments. (3) Its relative safety factor. (4) The relative desirability of fixed-interest instruments at any given time vs. flexible payout instruments such as common stocks.



At present, Treasury bonds are considered to be in the top echelon of safety on the U.S. bond scale. If there is any doubt, it is not about the safety of U.S. Treasury bonds compared to other U.S. bonds, but rather it is the question of the safety of the U.S. Government itself in view of its giant inflationary propensities. In other words, if the U.S. continues to inflate and print money, how safe is the dollar itself? Secondly, if a new Administration (Nixon's, for instance) decides to defend the dollar against inflation, that Administration will have to use higher interest rates, and higher interest rates will mean pressure on fixed payout instruments such as bonds.

These are the two factors which I believe are exerting pressure on bonds at this time. A third consideration which most people are not thinking about at all was covered in Letter 405. This is that the U.S. is now living way over its head. The U.S. is spent up, and need for current income is overwhelming (for instance, even the Social Security program is dependent upon current income rather than upon assets or money put aside). Any decline in the Government's tax receipts due to a business recession would exert fantastic pressure on the Treasury for new funds.

The classical view is that a recession eases the need for money, and interest rates during a business recession are thereby lowered. But with the current built-in need for funds (stemming from Vietnam, the huge defense program, the giant social welfare programs, etc.), the U.S. would be faced with two alternatives in event of recession: (1) mass reduction of expenses, (2) entrance into the bond market on an unprecedented scale.

It is the latter which scares the bond market. For no one seriously believes that in the event of recession the U.S. would attempt to cut expenses in order to offset a drop in tax receipts. In a dilemma of raising more money or spending less, the route to raising more money would almost surely win.

Thus, I would expect any business recession to confound the classicists at this time in that it would ultimately produce record interest rates as the Treasury stepped into the money market to take on all comers for funds.

It is interesting to me that the $4\frac{1}{4}$ bonds of 1987-92 have already erased more than half of their rally-gains of 1968 and are now back in the low 83 range (see chart). My guess is that the bear market in bonds (which has been going on since 1946) is not yet over, and that some time in the next year or so we will see the $4\frac{1}{4}$'s pictured here go crashing to new lows as the Government runs interest rates through the roof in a frantic effort to siphon off all available funds.

There is, however, one calculated way in which the Government might attempt to lower interest rates. That would be to raise the price of gold substantially, thereby boosting real reserves and also removing pressure on the dollar. An international re-valuation of currencies with intelligent adjustments of each currency could go a long way towards easing the international monetary tension.

GOLD: Nothing comes easy. So Dr. Karl Blessing, President of the West German Bundesbank learned when he issued his statement last week at the nine-nation meeting in Washington. The statement read short and terse: "The governors unanimously agreed on a common position based on the Washington declaration of March 17, 1968, regarding the disposal of newly mined gold. It has, however, not proved possible to reach agreement with South Africa at this meeting."

The background was this. Last March, in the face of an unprecedented gold rush which had removed over $3 billion in gold reserves from world central banks, the bankers decided to establish a "two-tier" gold system. The central bankers would buy or sell gold among themselves at a price of $35 per ounce. They would stop intervening in the private gold market to maintain the $35 gold price. Finally, they deemed that they "no longer feel it necessary to buy gold" on the open market. The $40 billion in Free World gold reserves was enough.

New York Times, Oct. 4

ACCORD REPORTED ON SALE OF GOLD

U.S. and European Nations Apparently Agree on Plan Concerning South Africa

I.M.F. COULD BUY SOME

Finance Minister Diederichs Indicates His Country Is Willing to Negotiate

New York Times, Oct. 5

SOUTH AFRICA BARS PROPOSAL ON GOLD

But Official States Nation Is Willing to Explore a Compromise on Offer

DETAILS NOT DISCLOSED

The Ten Major Financial Countries Say They Will Continue Old Policies

Everthing was set on Oct. 4, except for one minor problem. Although the 9 nations agreed on what they wanted, their "proposition" had not yet been submitted to South Africa. When they did submit it, the answer came back — "No."

The U.S. Treasury hopefully interpreted the "agreement" to mean that the central bankers would not buy any of the $1.4 billion of annual newly-mined gold. This would force South Africa (so the U.S. thought) to dump gold on the free gold market, thereby keeping steady pressure on the free market price of gold and holding the price of gold near or even below $35 per ounce.

Then the truth came out. Central bankers had no intention of allowing gold to drop below $35 an ounce. Since a large part of their monetary reserves were in gold, they were hardly willing to allow gold to go below the $35 floor. Central bankers made it known that should gold get down to $35, they would support the price. But the entire argument remained academic since the price of gold never came near $35 per ounce. Since August, in fact, the price of gold has remained above $39 per ounce.

European bankers now want to purchase more gold from South Africa, despite the March, 1968 agreement and despite the U.S. The Germans, in particular, have been trying to work out an agreement between the U.S. and the other nations which would

permit official additional purchases of gold. South Africa has said "No" to the proposition put forth to it last week, a proposition that stated that the South Africans would be given a $35 floor for gold, and that there would be no abuse of its virtual monopoly gold power. S. Africa made a counter-proposal: it wants considerable freedom to sell gold to both the central bankers and the free market.

Then the real truth emerged. Last week S. Africa's Finance Minister Diederichs announced that he wants an "orderly increase" in the price of gold to prevent an ultimate forced increase resulting from "an international financial crisis." South Africa is implying that it will be patient about waiting for a better deal on gold. It is under little pressure to sell. Its finances are in good shape, and it is ready to play the waiting game.

There are two potential aces-in-the-hole for S. Africa. One is France, which wants a jettisoning of the dollar as a reserve currency. France wants gold to reign supreme, and DeGaulle seems to be implying that he would be interested in a deal whereby he would allow a British entrance into the Common Market if the world would move to the gold standard and a higher price for gold. Two weeks ago, in fact, France again applied pressure by vetoing British entrance into the Common Market.

The second ace-in-the-hole for S. Africa is the possibility that Nixon will become President, and that Nixon may take the bull by the horns and increase the price of gold. Nixon did not answer a question on gold when asked by Fortune Magazine about his gold position. It is known that many of Nixon's financial advisors are conservatives. And it is possible, reasons S. Africa, that rather than face additional gold rushes in the future, Nixon will face the issue early in his Administration by raising the price of the yellow metal.

At any rate, France, Russia, South Africa and perhaps a new U.S. Administration could all have a vested interest in a higher price for gold. In view of this, S. Africa, producer of 70% of the Free World's gold, is watching and waiting while making no deals.

NOTES & QUOTES: From the Oct. 7 Business and Investment Timing by Anthony Gaubis: "From the investment or stock market point of view, it may be of interest to note that the previous record level of consumer borrowing for any single month was recorded in April, 1965. It may or may not be a coincidence that this was followed by a 15% shake-out in the stock market (or roughly 140 Dow Jones points at current levels) about two months later. In the spring of 1965, as is the case today, inflation psychology was at a high pitch because of the sharp rise in the cost of living; the banking system was operating on the basis of moderate net borrowed reserves; and the Federal Reserve Board was expanding the credit supply, and even permitting a moderate decline in short-term money rates, in order to help the Government with its deficit financing."

From the Oct. 4 Myers' Finance Review: "If the ultimate money is to be the U.S. paper $, this clearly means that the U.S. has a monopoly on world money. It can print as many $'s as it likes, buy as many industries in France, Australia or Sweden as it likes—without any more effort than writing figures in a book. TRULY AND LET'S NOT MISTAKE THIS—YOU ARE LOOKING AT A BASIC TRUTH.

"The U.S., without exerting effort, can buy the world.

"If, however, gold is the ultimate money, then the U.S. would have to earn gold in order to print $'s to buy industries in France, Sweden or wherever. So would all countries have to earn gold. And so all countries are on an equal footing. And by their effort, and not through the slavery of others—would they then enjoy a high or low standard of living according to their efficiency."

From a recent interview (for the San Diego Union) with Harrison Reader, a securities firm executive just back from London:" 'The British are spending money like it is going out of style,' Reader said. 'They fully expect another devaluation.' The American visitor found the ordinary citizen in Britain 'buying everything possible on time payments' and plunging in the stock market as an inflation hedge. Racetracks have doubled the minimum bet and the annual yearling sales brought 45 per cent higher prices than a year earlier, Reader noted.

"The recklessness is running so high, he said, that one British brokerage firm recently opened a branch featuring pretty models as securities salesladies. They had received broker training."

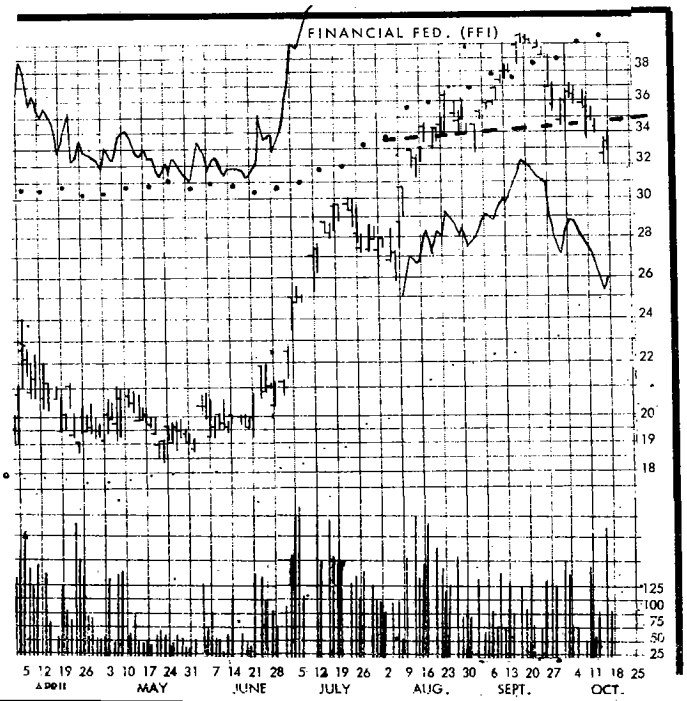
From the Oct. 8 Janeway Letter in which Janeway writes bearishly of the bond market: "The worst is yet to come—for two simple and sufficient reasons. The first is psychological: the (bond) market no longer has any blue sky to spot beyond the present peak, as it did while it was still beguiled when LBJ was romancing it with his promised surtax. The second is political: Nixon is making a clear, forcible and irrefutably documented case for the need to program comprehensive and, by definition, 'mega-buck' scale catch-up projects on military fronts not directly related to

Vietnam (again, no surprise to our readers, who have been on notice that, with the Cold War heating up and inflating into a two-front affair, a day of reckoning is overdue for McNamara's technique of budgetary embezzlement of 'other' military programs into under-the-table financing for Vietnam)."

The current issue of Indicator Digest carefully documents the need for a higher price for gold, showing that the world monetary base (gold) is simply not keeping up with the expansion in world trade. Then, in an aside, Indicator notes: "The reason cited most often for our reluctance to raise the price of gold is that Soviet Russia also produces the metal and will derive substantial financial benefits from the price increase. This is tantamount to saying that we should not try to discover a cure for cancer because a guy we thoroughly despise has the disease and might be cured by our discovery!"

DOW THEORY MARKET LABORATORY PAGE

With the upward push in money rates, pressure will mount on mortgage money and competition will intensify for funds. One of the first groups to be affected by this new development has been the Savings and Loan shares, the previous darlings of 1968. Typical of this group is FFI (chart courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62002). Here we see the run-up which more than doubled the price of FFI in a period of four months. But since August, FFI has been forming a "head-and-shoulders" top. It was of the compact, symmetrical variety which so often provides real force on the downside following completion. Last week FFI completed the top when it broke below the neckline (35 area) in a downside gap, then pulled back. I would guess, on the basis of this chart, that FFI has seen its highs.



Homestake, the only U.S. gold producer listed on the N.Y.S.E. recently split its shares two for one. Note the series of three declining tops during 1968 (market 1, 2, 3, on the Traders Research daily chart). The recent split shares have rallied up to the 36½ area, and as seen on the chart a move up to 37 or better would take HM through peak 3, and put the stock in a good position to attack point 2 in the 40 area.

Most interesting to me is the rather unusual "saucer-bottoming" pattern in HM as drawn on the chart (curved line). Such saucering patterns usually denote careful accumulation. If true, it should not be long before HM moves above 37 in a definite upside "break-out." I would think that 37 or better for HM would be enough to signal a general rise in most of the other gold shares. Because of the greater interest brought on by the HM split, I believe HM is again the leader in the listed gold equities.